PART ONE

# How to Pick Mutual Funds

# I

# Know What Your Fund Owns

MOST OF US wouldn't buy a new home just because it looked good from the outside. We would do a thorough walk-through first. We'd examine the furnace, check for a leaky roof, and look for cracks in the foundation.

Mutual fund investing requires the same careful investigation. You need to give a fund more than a surface-level once-over before investing in it. Knowing that the fund has been a good performer in the past isn't enough to warrant risking your money. You need to understand what's inside its portfolio—or how it invests. You must find out what a fund owns to know if it's right for you.

The stocks and bonds in a fund's portfolio are so important that Morningstar analysts spend a lot of their time on the subject; news about what high-profile fund managers are buying is a constant source of e-mail chatter in the office. Our analysts examine fund portfolios of holdings, talk with the managers about their strategies in picking those holdings, and check on recent changes to the lineup. Knowing what a fund owns helps you understand its past behavior, set realistic expectations for what it might do in the future, and figure out how it will work with the other funds you own.

At the most basic level, a fund can own stocks, bonds, cash, or a combination of the three. If it invests in stocks, it could focus on U.S. companies or venture abroad. If the fund owns U.S. companies, it might invest in giants such as General Electric or Microsoft or seek out tiny companies that most of us have never heard of. A manager may focus on fast-growing companies that command high prices or on slow-growth (or no-growth) firms trading at bargain-basement prices. Finally, managers can own anywhere from 20 to hundreds of stocks. How a manager chooses to invest your money has a big impact on performance. For example, if your manager devotes much of the portfolio to a single volatile area such as technology stocks, your fund may generate high returns at times but will also be very risky.

A fund's name doesn't always reveal what a fund owns because funds often have generic handles. Take the intriguingly named State Street Research Aurora and American Century Veedot funds. If you were to skim over only their names, you would be hard-pressed to glean that the former focuses on small companies that are trading cheaply, whereas the latter is a go-anywhere fund that uses computer models to help direct investments. Nor do the objectives that the firm identifies in its prospectus always give you clues about its portfolio. Aegis Value Fund focuses on tiny, budget-priced stocks, whereas Alliance Premier Growth focuses on fast-growing stocks of large companies. The Aegis fund returned 43% in 2001, whereas the Alliance fund lost 25% that year. Yet both funds are classified as "Growth" funds in their prospectuses. To discern their differences, you'd need to dig beneath the funds' stated objectives.

### Using the Morningstar® Style Box™

A desire to help investors choose funds based on what they really own—instead of on what funds call themselves or how they've performed recently—was precisely what inspired Morningstar to develop its investment style box in the early 1990s. The style box provides a summary of a given fund's portfolio—it does not tell you about every security the fund owns, but the box gives a quick and clear picture of the portfolio as a whole. (To check out a fund's current style box, go to Morningstar's Web site, www.morningstar.com, and type in a fund's name or ticker.) The style box isolates two key factors that drive a stock fund's performance: the size of the stocks the fund invests in, and

the type of companies it invests in—rapidly growing companies, slow growers, or a combination (see Figure 1.1).

To figure out which square of our stock style box a whole fund portfolio lands in, we first analyze each and every stock in that portfolio. We look at a stock's market capitalization (the number of shares outstanding multiplied by the stock's price), categorizing each holding as small, medium, or large. We then figure out the portfolio's overall capitalization. The calculation resembles a simple average, except that it takes outliers into account (e.g., large-company stocks in a mostly small-cap portfolio) without letting them completely distort the results. A portfolio's capitalization—whether the fund invests mainly in small, medium-size, or large companies—forms the vertical axis of the style box.

Once we've pinpointed what size stocks a fund invests in, we plot its investment style on the horizontal axis of the box. We classify stocks as value (think stodgy dividend payers like Philip Morris), core (steady but not scintillating growers, e.g., Procter & Gamble), or growth (highfliers like eBay or biotech firm Amgen). We score each stock in several ways ranging from value

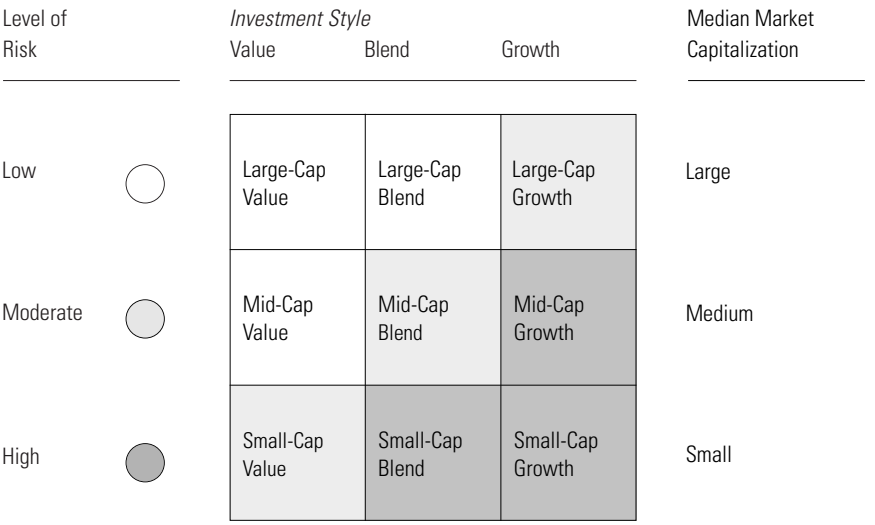


Figure 1.1 The Morningstar style box is a nine-square grid that provides a quick and clear picture of a fund's investment style.

criteria such as dividend yields and price/earnings ratios to growth factors such as earnings and sales growth. This helps us decide whether to classify a stock as growth, value, or core. Once we have classified each stock's investment style, we then classify the entire portfolio, based on which square of our style box most of its stocks land in.

Understanding the difference between a growth stock and a value stock is critical to understanding what makes a fund tick. Growth stocks typically enjoy strong growth in earnings that is often related to a hot new product or service. Because the market expects good things from these fast growers, and earnings growth usually drives a higher share price, investors are willing to pay more for the shares than they will pay for slower growers.

Value stocks, on the other hand, look like growth stocks' less successful cousins. These companies' earnings are usually growing slowly, if at all, and they often operate in industries that are prone to boom-and-bust cycles. So why does anyone bother with these underachievers? The answer is, because they're cheap. Managers who focus on value stocks are willing to put up with unattractive historical earnings growth because they think the market is being overly pessimistic about the company's future. Should things turn out better than the market thinks, the bargain-hunting fund manager stands to profit.

As you might expect, different-style funds tend to behave differently in various market and economic environments, which is why the style box can be so handy. Quickly eyeballing a fund's style box can give you some indication of how it might perform in good markets and in bad. As a rule of thumb, the large-cap value square of Morningstar's style box is considered the safest because large-cap companies typically are more stable than small ones (the high-profile blowups of giants like Worldcom and Enron notwithstanding). And in down markets, when investors are concerned that stock prices could be too high across the board, value funds' budget-priced stocks don't have very far to fall.

Funds that hit the small-growth square of the style box are usually the riskiest. The success of a single product can make or break a small company, and because small-growth stocks often trade at lofty prices, they can take a disastrous tumble if one of the company's products or services fails to take off as the market expects. These funds can deliver glittering riches in upmarkets,

though: In 1999, the average small-growth fund returned 58% (for more on the correlation between investment style and risk, see Chapter 3).

### Using the Morningstar Categories

Despite the usefulness of the Morningstar style box, it's just a snapshot of the fund's most recent portfolio. When you are selecting a fund to play a particular role, such as adding large-cap value stocks to your portfolio, you want to be confident that it actually has played that role over time. That's what we have in mind when we plug funds into Morningstar categories. We assign funds to categories based on the past three years' worth of style boxes. A single portfolio could reflect a temporary aberration—maybe the fund's holdings have been doing really well, so they have grown from small- to mid-cap as stock prices have gone up. But because a fund's category assignment is based on three years' worth of portfolios, it gives you a better handle on how the fund typically invests.

Our categories are based on the style box with style-specific categories ranging from large value in the upper left corner to small growth in the lower right corner. We also carve out some categories for specialized funds. To name a few, there are categories for high-yield bond funds, Japan funds, and health care funds. Morningstar slots funds into about 50 categories (see Figure 1.2).

As with the style box, Morningstar categories pick up where fund names and prospectus objectives leave off. They help you figure out how a fund actually invests, which in turn lets you know how to use it in your portfolio. If you're looking for a good core stock fund, you might begin your search within the large-blend category. Funds that land there usually invest in the biggest, best established U.S. companies and buy stocks with a mix of growth and value characteristics. Thus, large-blend funds tend to be a decent bet in varied market and economic conditions. Although they may not lead the pack too often, neither are they apt to be left completely behind. (This subject is discussed in detail in Part Two.)

By targeting funds in different categories, you are much more likely to pull together a diversified portfolio than if you rely on funds' prospectus objectives to show you the way. An investor focusing exclusively on prospectus objectives might think he or she had a diversified mix in a portfolio that consisted of Dreyfus Premier Value (with a prospectus objective of Growth),

| | | |
|---|---|---|
| *Domestic Stock* | Large Value | Mid-Cap Blend |
| | Large Blend | Mid-Cap Growth |
| | Large Growth | Small Value |
| | Mid-Cap Value | Small Blend |
| *International Stock* | Europe Stock | Pacific Stock ex-Japan |
| | Latin America Stock | Japan Stock |
| | Diversified Emerging Markets | Foreign Stock |
| | Pacific Stock | World Stock |
| *Specialty Stock* | Communications | Precious Metals |
| | Financial | Real Estate |
| | Health | Technology |
| | Natural Resources | Utilities |
| *Hybrid* | Conservative Allocation | Bear |
| | Moderate Allocation | |
| *Specialty Bond* | High-Yield Bond | Emerging Markets Bond |
| | Multisector Bond | Bank Loan |
| | International Bond | |
| *General Bond* | Long-Term Bond | Short-Term Bond |
| | Intermediate-Term Bond | Ultrashort Bond |
| *Government Bond* | Long-Term Government | Short-Term Government |
| | Intermediate-Term Gov't | |
| *Municipal Bond* | Muni National Long | Muni Ohio |
| | Muni National Intermediate | Muni Minnesota |
| | Muni NY Long | Muni Maryland |
| | Muni NY Intermediate | Muni Single State Long |
| | Muni CA Long | Muni Single State Intermediate |
| | Muni CA Intermediate | Muni Short-Term |
| | Muni Florida | Muni High-Yield |
| | Muni Pennsylvania | |
| | Muni New Jersey | |

Figure 1.2 Morningstar's category breakdown for the fund universe.

Hancock Sovereign Investors (Growth and Income), and Armada Large Cap Value (Equity-Income). Diversified? Not so fast. According to their Morningstar categories, which take their underlying holdings into account, all three funds are actually large-cap value offerings.

### Examining Sector Weightings

Checking a fund's category and style box can go a long way toward helping you know what a fund is all about, but it may not tell the whole story. Not all funds that land in the same style box or even the same category will behave the same way. Both Fidelity OTC and Marsico Growth land in the large-cap growth category. Yet they have tended to own very different kinds of large-growth stocks. In the late 1990s, Fidelity OTC often dedicated more than half of its assets to technology-related stocks—as much as 75% at one point. Marsico Growth also staked a sizable amount on tech, but its position topped out at 40% of the portfolio.

What a difference those two approaches made! A heavy weighting in the tech sector was a boon in 1999, when investors adored technology stocks. Fidelity OTC soared an amazing 73% that year, whereas Marsico Growth gained 53%. A 53% gain is an impressive return in its own right, but if you had put $10,000 in each fund at the start of the year, your Fidelity OTC investment would have been worth $2,000 more than Marsico Growth at the end of 1999. But anything that produces such strong returns can also prove an Achilles' heel, and that's exactly what happened to Fidelity OTC; when tech collapsed in 2000, it lost 26%, whereas Marsico Growth lost 16%. The moral of the story isn't that a technology-heavy fund like Fidelity OTC is automatically a bad idea, but, that people who own it, should limit their investment in it and make sure to diversify with other funds.

Morningstar calculates a fund's sector exposure based on the percentage of its portfolio that is committed to stocks in each of 12 industry groupings. We also cluster those sectors into one of three "supersectors": information, services, and manufacturing (see Figure 1.3). We developed the broader classification system because the sectors within our supersector groupings tend to behave in a similar way in various stock market environments. In the recent market downturn of 2000 through 2002, every sector in our information supersector—hardware, software, telecommunications, and media—incurred


Figure 1.3 Morningstar's sector breakdown. Twelve sectors are divided into three supersectors representing broader economies.

terrible losses. If all the funds in your portfolio heavily concentrate their holdings in a certain supersector, it can be a strong indication that your portfolio needs exposure to other parts of the economy. Similarly, if you have a job in a technology-related field, you will want your portfolio to have plenty of exposure outside the information supersector because much of your economic well-being (through your job) is already tied to that area.

### Examining Number of Holdings

To understand what a particular fund is up to, knowing the number of stocks it owns can be just as important as any of the other factors we have discussed. For obvious reasons, whether your fund holds 20 stocks or hundreds of them will make a big difference in its behavior. (Because Securities and Exchange Commission regulations limit the percentage of its assets that a fund can commit to each holding, fund portfolios rarely have fewer than 20 stocks.) Janus Twenty, which divides its portfolio among a small number of stocks, is likely to see a lot more gyrations in its performance—for better and for worse—than one that spreads its money wide like Fidelity Contrafund (it owns more than 400 stocks), even though both are large-growth funds.

### Checking Up on the Frequency of Portfolio Changes

In addition to checking categories, style boxes, sectors, and number of holdings (phew!), a fund's turnover rate is another important factor when you're judging a fund's style. Turnover measures how much the portfolio has changed during the past year and shows approximately how long a manager typically holds a stock. For example, a fund with a turnover rate of 100% has

a typical holding period of one year; a fund with 25% turnover holds a stock for four years on average.

Turnover is a pretty simple calculation: To figure it out, fund accountants just divide a fund's total investment sales or purchases (whichever is less) by its average monthly assets for the year.

A fund's turnover rate can give you important insights into a manager's style. It can tell you whether a manager tends to buy and hold, picking stocks and sticking with them for the long haul instead of frequently trading in and out of them. To give you a basis for comparison, stock funds on average have turnover rates of 114%. We consider a fund's turnover rate to be notably modest when it's 30% or lower.

Insights about turnover are useful because managers who keep turnover low tend to practice low-risk strategies, whereas high-turnover funds tend to be aggressive and much riskier. That gets back to investment style: As a rule of thumb, the more value-conscious your manager is, the more patient he or she will tend to be with the holdings in the portfolio. Meanwhile, growth-oriented fund managers often employ high-turnover strategies, and as we mentioned, higher-priced stocks often equal more risk.

High turnover can also spell tax consequences for investors. A manager who sells stocks at a profit incurs a taxable gain, which the fund is required to distribute to investors. If you own the fund in a taxable account instead of in a 401(k) or Individual Retirement Account, you'll have to pay taxes on that distribution. If the fund has a high turnover rate, the tax consequences could cut into returns you would otherwise pocket.

As if that weren't enough, high-turnover funds can incur higher trading costs than low-turnover offerings. When we say *trading costs* we're not just referring to the dollars that the fund pays its brokers to execute the trade (though those charges can cut into your returns, too). Rather, we're also referring to the fact that big funds can "move the market" when buying and selling their shares. Say a big fund like Fidelity Contrafund wants to get out of one of its largest positions in a hurry. Because Contrafund is flooding the market with shares, it may have to accept lower and lower prices for those shares as it unloads its position. The more the fund engages in such trading, the less attractive its average purchase and sale prices will be, and the less its shareholders will profit. (We probably shouldn't pick on Contrafund in

| Fund Name | Category | Turnover % |
|---|---|---|
| Dreyfus Appreciation | Large Blend | 5 |
| Mairs & Power Growth | Large Blend | 8 |
| Dodge & Cox Stock | Large Value | 10 |
| Vanguard Health Care | Health | 13 |
| Gabelli Asset | Mid Blend | 15 |
| Third Avenue Value | Mid Blend | 16 |
| T. Rowe Price Equity-Income | Large Value | 17 |
| Longleaf Partners | Mid Value | 18 |
| Liberty Acorn | Small Growth | 20 |
| Selected American | Large Blend | 20 |

Figure 1.4 Ten great low-turnover funds.

particular—it has been a strong performer, despite its huge asset base and high-turnover approach. But in general, a fund that combines a high-turnover strategy with a big asset base is fighting an uphill battle.)

For all these reasons, we think you greatly improve your portfolio's odds of good long-term performance if you put the bulk of your assets in low-turnover funds. Figure 1.4 provides a list of some of our favorites.

**Investor's Checklist: Know What Your Funds Own**

- Use a fund's Morningstar style box as a visual guide to learn what the fund owns and how it's apt to behave in the future.
- When assembling a diversified portfolio, look for funds that land in a variety of Morningstar categories.
- Look in Morningstar's large-blend category for core funds that are unlikely to go too far out on a limb. Want something with a little more zip? Growth and/or small-cap categories are a good place to start.
- Check a fund's sector weightings relative to its category peers to see if the fund is betting heavily on a given area of the market.
- If you're concerned about risk, look for funds that spread their assets over many holdings. Fewer holdings equal more risk.
- Put the bulk of your portfolio in low-turnover funds, which are generally less risky and more tax-efficient.